

# What Happens in China Stays in China: U.S. Tax Traps for Immigrant Investors

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by Alan W. Granwell, William M. Sharp Sr., and Ajay C. Whittemore

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Chinese and other investors<sup>1</sup> who become lawful permanent residents of the United States (green card holders) under the Immigrant Investor Program, better known as the EB-5 program, may believe that what happens in China stays in China for U.S. federal income tax and reporting purposes. Unfortunately, that is not the way it works.

The intersection of the U.S. immigration and tax provisions applicable to EB-5 investors is a trap for the unwary with potentially detrimental and costly consequences. Although the investor generally is aware of the continued application of the Chinese tax system, he may be unaware of the breadth of application of the U.S. tax system that will apply once he becomes a lawful permanent resident and enters the United States under that status, resulting in exposure to both the Chinese and the U.S. worldwide tax systems.

This article provides a high-level background of the EB-5 program, describes the U.S. federal tax consequences of becoming a lawful permanent resident under the immigration law, and makes practical suggestions as to how an EB-5 investor can avoid or mitigate the detrimental U.S. federal tax consequences, depend-

ing on when the investor becomes aware of the applicable U.S. tax and information reporting ramifications.

### The EB-5 Program

Established in 1990, the Immigrant Investor Program allows wealthy foreign individuals to obtain permanent residency visas by investing in certain eligible U.S. commercial enterprises. The EB-5 program has grown significantly in popularity in recent years, and *The Wall Street Journal* recently referred to it as “an engine of job creation.”<sup>2</sup> According to government reports, the EB-5 program resulted in the issuance of 7,641 green cards in fiscal 2012, triggering over \$1.8 billion in U.S. investments.<sup>3</sup> This demand from wealthy foreigners seems likely to continue unabated, despite some reported instances of fraud in the sale of investments in EB-5 enterprises, as was reported in *The New York Times*.<sup>4</sup>

The EB-5 program generally requires applicants to make capital investments of at least \$1 million in eligible U.S. commercial enterprises, but most applicants

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<sup>1</sup>We illustrate the potentially disadvantageous tax consequences by reference to EB-5 investors from China because Chinese nationals have constituted the overwhelming proportion of overall EB-5 investors in recent years.

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<sup>2</sup>James V. Grimaldi, Angus Loten, and Vanessa O’Connell, “Chinese Investors Get Picky Over U.S. Visa-for-Cash,” *The Wall Street Journal*, Mar. 19, 2013, at A1.

<sup>3</sup>*Id.*

<sup>4</sup>Ann Lee, “Making Visas-for-Dollars Work,” *The New York Times*, Apr. 16, 2012, at A19.

qualify for a reduced investment of \$500,000 by investing in enterprises located in high-unemployment or rural areas designated as targeted employment areas.<sup>5</sup> All EB-5 investors must demonstrate that their investment will create or preserve employment for at least 10 American workers.<sup>6</sup>

Not surprisingly, a significant number of EB-5 investors are affluent Chinese nationals, many of whom seek better schooling for their children, a refuge from China's mounting environmental crisis, and the opportunity to diversify their financial holdings in the U.S. economy. As a consequence, approximately 80 percent of the 7,641 visas issued in fiscal 2012 were issued to Chinese nationals.<sup>7</sup>

### Rights and Obligations

An individual who obtains lawful permanent resident status obtains certain rights and is subject to certain responsibilities. The rights include the privilege of living permanently and working in the United States, and the obligations include becoming subject to residency-based U.S. federal income tax and reporting requirements as further discussed below.

### U.S. Income Tax Residency Status

An EB-5 investor who becomes a lawful permanent resident of the United States is considered a resident for U.S. federal income tax purposes and is subject to U.S. taxation on a worldwide basis. U.S. residency status generally begins in the calendar year in which the individual is lawfully admitted to the U.S. for permanent residence.<sup>8</sup>

<sup>5</sup>Of the annual EB-5 visa allotment of 10,000, 3,000 are reserved for investors in targeted employment areas.

<sup>6</sup>Available at <http://www.uscis.gov/portal/site/uscis/> (follow "Permanent Workers" link under "Working in the US"; then follow "Employment-Based Immigration: Fifth Preference EB-5").

<sup>7</sup>Grimaldi et. al, *supra* note 2.

<sup>8</sup>Section 7701(b)(1)(A)(i); reg. section 301.7701(b)-4(a). This rule assumes that the EB-5 investor has not met the substantial presence test. The residency starting date for an alien individual that satisfies both the substantial presence test and the green card test will be the *earlier* of the first day the individual is physically present in the United States as a lawful permanent resident of the United States or the first day during the year that the individual is present for purposes of the substantial presence test. Reg. section 301.7701(b)-4(a). Thus, if an EB-5 investor were to meet the substantial presence test in 2013 based on his physical presence in 2011, 2012, and 2013, the investor would become a resident for U.S. federal income tax purposes on his first day of physical presence in 2013 even if the investor were to receive and enter the United States on a green card subsequently. In determining the first day of presence for purposes of the substantial presence test, presence in the United States for up to 10 days is ignored if, while present in the United States, the taxpayer had a closer connection to a foreign country than to the United States. Reg. section 301.7701(b)-4(c)(1).

Once permanent residency is obtained, an individual generally continues to be a lawful permanent resident until lawful permanent resident status is either revoked or administratively or judicially determined to have been abandoned.<sup>9</sup> In the absence of a revocation or determination, a green card holder is a resident for U.S. tax purposes even if the person resides in a foreign country and "comes to the United States so infrequently that, on scrutiny, he is no longer legally entitled under U.S. immigration law to permanent resident status."<sup>10</sup> Thus, a green card holder who does not relinquish his green card continues to be treated as a U.S. income tax resident.

A green card holder ceases to be a lawful permanent resident for U.S. federal income tax purposes when he "commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country" and notifies the IRS of the commencement of such treatment without waiving the benefits of such treaty applicable to residents of the foreign country (the treaty tiebreaker rule, discussed below).<sup>11</sup>

EB-5 investors are initially granted permanent residency for a two-year period on a conditional basis, after which the conditional visa can be converted to permanent residency status. The conditional nature of the green card during the initial two-year term does not alter the U.S. income tax residency status of EB-5 investors because conditional permanent residency status confers "the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws."<sup>12</sup>

### U.S. Income Tax Hazards for EB-5 Investors

#### Worldwide Taxation and Information Reporting

As U.S. income tax residents, EB-5 investors are subject to all of the U.S. tax rules that apply to U.S. taxpayers, including taxation on worldwide income, the anti-deferral rules, and expansive information reporting requirements regarding foreign activities, assets, gifts, and inheritances.

Chinese EB-5 investors often will retain significant holdings in P.R.C. financial accounts and business investments because of Chinese currency controls that restrict individuals from converting and removing from

<sup>9</sup>Section 7701(b)(6).

<sup>10</sup>General Explanation of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. (1984). Congress required a revocation or formal determination of abandonment to terminate residence in order to prevent aliens from attempting to retain an apparent right to enter or remain in the United States while attempting to avoid the tax responsibility that accompanies that right.

<sup>11</sup>Section 7701(b)(6).

<sup>12</sup>8 C.F.R. section 216.1.

China more than the equivalent of \$50,000 per year.<sup>13</sup> EB-5 investors who either own or have signature authority over bank accounts in their country of origin (or any other non-U.S. jurisdiction, for that matter) are required to file Fin CEN Form 114, "Report of Foreign Bank and Financial Accounts" (FBAR), in any year in which the aggregate value of such account exceeds \$10,000.<sup>14</sup> Willful failure to timely file an FBAR can result in penalties for as much as half the value of the reportable foreign accounts, and even non-willful failures to file can result in penalties of as much as \$10,000 per violation.<sup>15</sup>

Beginning with the 2011 tax year, in addition to filing an FBAR, EB-5 investors must also disclose foreign account ownership on Form 8938, "Statement of Specified Foreign Financial Assets." Failure to file Form 8938 can result in a penalty of \$10,000, which can increase by \$10,000 per 30-day period after the initial 90-day period following the failure to file (the maximum penalty is \$50,000).<sup>16</sup>

Additionally, many EB-5 investors will continue to own, and often manage, corporations based in the P.R.C. (or other foreign jurisdictions). The U.S. anti-deferral rules, which were designed to prevent U.S. taxpayers from achieving tax deferral through foreign corporations conducting certain activities abroad, pose a serious threat to unwary EB-5 investors who become U.S. tax residents without proper advance planning.

Further, ownership of foreign corporations or other entities triggers filing requirements, such as Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations." Failure to file the Form 5471 can result in penalties of \$10,000 per violation.<sup>17</sup> Interests in foreign partnerships and trusts must also be reported, as well as foreign gifts and inheritances, which, albeit not taxable, must be reported if over \$100,000, as failure to do so will trigger additional penalty exposure.<sup>18</sup>

Additionally, EB-5 investors risk unfavorable attention from the IRS, because, by definition, they are highly wealthy immigrants. By simply accessing State

Department visa information, the IRS can target EB-5 investors for examination with little difficulty.<sup>19</sup>

In connection with its increased focus on international enforcement, the IRS in 2009 announced the formation of the global high-wealth industry group, which is intended to scrutinize "high wealth individuals and their related entities — which can often have an international component."<sup>20</sup> Many EB-5 investors may therefore unwittingly come within the scope of this IRS initiative at a time of heightened enforcement effort and increasingly complex compliance requirements.

Apart from the application of the U.S. federal income tax, EB-5 investors who become green card holders must be aware of the potential exposure to transfer taxes in the form of the federal gift and estate tax and also to potential state income taxation, as discussed below.

### Federal Gift and Estate Tax Considerations

An EB-5 investor should be aware of the potential application of the federal gift and estate tax. An investor who becomes a resident under these provisions will be subject to potential taxation on worldwide *inter vivos* and testamentary gratuitous transfers. For U.S. federal estate and gift tax purposes, an alien is a resident of the United States if he is a domiciliary of the U.S. for estate and gift tax purposes. Note that the test for residence is different for income tax than for estate and gift tax purposes.

Domicile is the strongest and most permanent connection of an individual with a place, and is established by physical presence, even for a brief period of time, accompanied by the individual's intent to remain indefinitely in that location. An individual's domicile is the place to which he intends to return whenever absent. The facts and circumstances of each individual case determine domicile, and residence without the requisite intention to remain indefinitely will not suffice, nor will intention to change domicile effect a change unless it is accompanied by actual removal. Once domicile is established, it continues unless a shift of physical location coupled with a change of intention occurs.<sup>21</sup>

<sup>13</sup>Circular of the State Administration of Foreign Exchange on Printing and Distributing the Detailed Rules on the Implementation of the Measures for the Administration of Individual Foreign Exchange (Jan. 5, 2007), available at <http://www.safe.gov.cn>.

<sup>14</sup>31 U.S.C. section 5314.

<sup>15</sup>31 U.S.C. section 5321(a)(5).

<sup>16</sup>Section 6038D(d).

<sup>17</sup>Section 6038(b)(1).

<sup>18</sup>Section 6046A; section 6048(a); Notice 97-34, 1997-1 C.B. 422.

<sup>19</sup>See United States Government Accountability Office, "IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden," at 17-18 (2010).

<sup>20</sup>Then-Commissioner Douglas Shulman, "Remarks Before the 22nd Annual George Washington University International Tax Conference," IRS News Release IR2009116 (Dec. 10, 2009).

<sup>21</sup>Generally, the factors enumerated below are considered in determining domicile in U.S. federal estate or gift tax cases:

(Footnote continued on next page.)

## State Tax

Although not all states impose an income tax, an EB-5 investor must be sensitive to the potential exposure to state income taxation. State income taxation varies from state to state. For example, some states, such as Florida, Nevada, and Texas, impose zero individual income taxes, while others, such as New York, New Jersey, and California, impose significant income taxes.

### ‘Exit’ Tax

As if the consequences described above were not sufficiently onerous, EB-5 investors who relinquish their green cards after becoming long-term residents<sup>22</sup> by maintaining that status during eight out of 15 years before relinquishment and qualify as covered expatriates<sup>23</sup> are enmeshed in yet another U.S. tax trap: the expatriation rules that apply to U.S. citizens and some long-term residents.

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- the duration of stay in the United States and in other countries and the frequency of travel both between the United States and other countries and between places abroad;
  - the size, cost, and nature of the alien’s houses or other dwelling places and whether those places were owned or rented;
  - the area in which the houses and other dwelling places are located;
  - the location of expensive and cherished personal possessions;
  - the location of the decedent’s family and close friends;
  - the place where the decedent maintained church and club memberships;
  - the location of the decedent’s business interests;
  - declarations of residence or intent made in visa applications for reentry permits, wills, deeds of gift, trust instruments, letters, and oral statements; and
  - motivation, especially health, pleasure, business, and avoidance of the miseries of war or political repression.

See Heimos, 837-2nd T.M., *Non-Citizens — Estate, Gift and Generation-Skipping Taxation*, Part III.C.4 for a more detailed enumeration of factors.

<sup>22</sup>Section 877A(g)(5). For purposes of determining whether the eight-year period is met, the time period is not necessarily eight full years; rather, if an individual becomes a green card holder on December 30 of the first year and relinquishes his green card on January 1 of the last year, the first year and the last year each count as one full year, with the consequence that only six additional full years are required. Thus, great care is needed to monitor the time period during which the individual has the green card in order not to inadvertently implicate the expatriation rules.

<sup>23</sup>Section 877A(g)(1). An individual is a “covered expatriate” if:

- a *tax liability test* is satisfied — that is, the average annual net income tax liability of the individual for the period of five tax years prior to expatriation is greater than \$155,000 (for 2013, increased annually);
- a *net worth test* is satisfied — that is, the individual’s net worth is at least \$2 million on the date of expatriation; or

(Footnote continued in next column.)

The expatriation rules may have detrimental income tax and gift or estate tax consequences. Under the income tax provisions, an exit tax is imposed on the expatriating individual. The exit tax is a notional U.S. income tax on the mark-to-market gain (offset by losses and in excess of \$668,000 (for 2013)) resulting from treating the worldwide property of the covered expatriate as sold on the day before the expatriation date for its fair market value.<sup>24</sup> Under the gift or estate tax, gifts or bequests by the covered expatriate (who, at the time of the gift or bequest, is not a U.S. person) to U.S. recipients will require the U.S. recipients to pay the gift or estate tax on the value of the gift or bequest at the highest marginal rate.<sup>25</sup> Note that the gift and estate tax is based on the value of the property at the time of the transfer, which may be many years after the expatriation, and the value of the gift or bequest is not capped by the value of the assets subject to the exit tax; further, for purposes of this tax, it makes no difference whether the gift or bequest is composed of U.S. or foreign situs property.

A green card holder ceases to be a lawful permanent resident of the United States, and thereby triggers the draconian expatriation tax rules, if:

- the individual’s status of having been lawfully accorded the privilege of residing permanently in the U.S. as an immigrant in accordance with immigration laws has been revoked or has been administratively or judicially determined to have been abandoned; or
- the individual:
  - commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the U.S. and the foreign country;

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- a *certification test* is not met — that is, the individual fails to certify under penalties of perjury that the individual has been compliant with all U.S. tax laws for the five-year period prior to expatriation.

Section 877(a)(2). This latter test can arise if the green card holder is not cognizant of the information reporting obligations with respect to offshore accounts investments.

<sup>24</sup>Section 877A(a). For purposes of determining gain, property that was held by an individual on the date the individual first became a resident of the United States shall be treated as having a basis on such date of not less than the fair market value of such property on such date unless the individual elects not to have such provision apply. Section 877A(h)(2). The exit tax does not apply to deferred compensation items, interests in non-grantor trusts, and some tax-deferred accounts. These items are subject to other tax regimes under the expatriation provisions. Section 877A(c).

<sup>25</sup>Section 2801(a). There are exclusions for gifts that qualify for the annual exclusion and for gifts and bequests that are subject to the marital deduction or the charitable deduction. Further, the U.S. gift or estate tax is reduced by the amount of any gift or estate tax paid to a foreign country with respect to the “covered” gift.

- does not waive the benefits of the treaty applicable to residents of the foreign country; and
- notifies the IRS of such treatment.<sup>26</sup>

### Coping With Two Competing Systems

For the approximately 5,000 Chinese nationals who obtained green cards in the fiscal year ending September 30, 2012, together with thousands of others from prior years, the pervasiveness of U.S. worldwide taxation and information reporting often comes into focus not long after the luster of the newly issued green card subsides and they ask themselves, “What have I done?”

It is not uncommon for Chinese EB-5 investors to retain their Chinese domicile, which will cause them to be treated as residents of the P.R.C.<sup>27</sup> So too, and irrespective of whether a Chinese investor retains Chinese domicile, many investors retain home-country assets and income stream after immigrating to the U.S. that raise unanticipated and intractable tax issues. For example:

- An investor may use a loan secured by a Chinese residence for EB-5 funding purposes. The residence continues to produce rental income after the investor becomes a U.S. resident and produces a benefit when the investor sells the property later on.
- An investor wholly owns a Hong Kong company with undistributed profits. The investor funds his EB-5 investment through a loan from his Hong Kong company and then causes the Hong Kong company to pay a dividend to the investor to repay the loan. The investor continues to own and manage the Hong Kong company from the U.S. and ultimately may sell the shares of the Hong Kong company.
- An investor uses liquid assets to fund his EB-5 investment and continues to hold foreign stocks, bonds, mutual funds, real estate, life insurance, or tax-deferred retirement accounts.
- An investor enters the U.S. on an F-1 non-immigrant visa to attend a U.S. university and uses gifts from parents (made outside the U.S.) to fund his EB-5 investment obligation.

The above fact patterns all pose U.S. tax and compliance issues because the EB-5 investor is a U.S. tax resident. The analysis and solutions become even more

complicated if the investor and his spouse reside in a U.S. community property jurisdiction.<sup>28</sup>

U.S. tax and compliance issues are exacerbated because the source of funds documentation (the I-526 Immigrant Petition by Alien Entrepreneur) that is required to be submitted by an EB-5 investor to the U.S. Citizenship and Immigration Services as part of the application provide the USCIS with detailed information about an investor’s income and assets. That information is potentially accessible by the IRS. The IRS also could obtain information from a foreign tax authority of a country that has entered into a double tax treaty or a tax information exchange agreement with the United States.

The fact that a Chinese EB-5 investor/green card holder is a dual resident and is subject to worldwide taxation by the P.R.C. and the U.S. is not the worst of the investor’s U.S. tax problems. Although dual residence in countries that impose worldwide taxation may result in international double taxation, operation of the foreign tax credit regimes generally should eliminate or at least mitigate to a large degree international double taxation.

The more significant issue is that Chinese investors, during their EB-5 application process, may never have been properly advised about the prospect of U.S. taxation of foreign-source income and the reporting of off-shore assets. When a Chinese investor learns of the U.S. tax consequences, typically after becoming a lawful permanent resident, he may be confused as to how to navigate this complex and unanticipated dilemma, which, if not timely and properly resolved, can prove costly.

The detrimental U.S. tax and reporting obligations and onerous penalties resulting from non-timely reporting (or willful non-reporting) of foreign-source income and associated information returns is particularly galling to Chinese investors that obtained green cards merely to educate their children in the U.S. or as a safety net in the event of political or economic exigency and intend to spend only limited time in the United States. Indeed, many Chinese green card holders continue to live or spend most of their time on the mainland, typically managing Chinese-based investments and businesses.

Many Chinese EB-5 investors inadvertently find themselves facing the above dilemma without having taken appropriate U.S. pre-residency planning measures, such as:

- making gifts of property situated outside of the U.S. to non-U.S. persons;
- selling appreciated assets;

<sup>26</sup>Section 7701(b)(6). See Notice 2009-85, 45 IRB 598, section 2.A. (Definitions).

<sup>27</sup>Individual Income Tax Law of the People’s Republic of China article 2. China, similar to the U.S., imposes a worldwide system of taxation, although in some situations the worldwide context is not enforced.

<sup>28</sup>Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

- disposing of foreign corporations that have primarily passive income; or
- using trusts (carefully).

Obviously, deliberative pre-residency planning is preferable to taking (often hurried) remedial action after becoming a U.S. tax resident.

As in all dilemmas, the Chinese investor has a choice. On one hand, the Chinese EB-5 investor can simply accept the consequences of dual residence; from a U.S. tax perspective, that status would mean that the Chinese investor is subject to taxation on worldwide income (subject to the FTC) and the full range of anti-deferral rules and reporting obligations on offshore transactions and investments. From a Chinese perspective, the investor would be subject to worldwide Chinese taxation as a resident.

On the other hand, if the Chinese investor believes that his residence is in China, and not in the U.S., he may invoke the 1984 China-U.S. income tax agreement to resolve the dilemma. The treaty provides a process to determine the country of residence when the internal laws of China and the U.S. each treat the investor as a resident. If treated as a resident of China, the investor will be treated as a nonresident of the United States for taxation (but not for reporting) purposes, as explained below.

A Chinese EB-5 investor who is a dual-resident taxpayer<sup>29</sup> thus can proactively resolve his tax status under the treaty, and, once residence under the treaty is determined, the treaty and the Treasury regulations provide guidance as to the consequences of that determination.<sup>30</sup> Unfortunately, because of a quirk in the somewhat antiquated treaty, the issue of dual residency under the treaty is not as easily resolved as it is in other treaty jurisdictions.

One potential downside to pursuing this treaty tiebreaker process is that if a green card holder is determined to be a Chinese resident rather than a U.S. resident and files U.S. nonresident tax returns, that filing may have adverse immigration consequences.<sup>31</sup> While the IRS may not be able to share information about the filing with USCIS,<sup>32</sup> there are circumstances in which USCIS may learn of a nonresident tax return filing. A green card holder who applies for naturalization must disclose any nonresident tax return filings, and the disclosure may result in denial of naturaliza-

<sup>29</sup>A dual-resident taxpayer is an individual who is considered a resident of the United States under the internal laws of the United States and also a resident of a treaty country under the treaty partner's internal laws. Reg. section 301.7701(b)-7(a)(1).

<sup>30</sup>Reg. section 301.7701(b)-7 (coordination with income tax treaties) is discussed *infra*.

<sup>31</sup>Reg. section 301.7701(b)-7(b).

<sup>32</sup>Tax return information is confidential and cannot be shared with other government agencies, except in limited situations where disclosure is warranted. Section 6103.

tion and revocation of permanent resident status.<sup>33</sup> A similar disclosure is required if a green card holder applies for a reentry permit to preserve permanent resident status against a finding of abandonment while residing temporarily abroad.<sup>34</sup> Disclosure of a nonresident tax return filing will generally result in denial of a reentry permit and may contribute to a finding of abandonment of status. Thus, a treaty tiebreaker election that is taken to mitigate the adverse tax consequences of obtaining a green card can put the green card at risk. Depending on the magnitude of the tax consequences, that may be an acceptable risk.

## The P.R.C.-U.S. Treaty 'Tiebreaker'

### General

Unlike most treaties, the treaty does not permit a dual-resident taxpayer to determine residence and take a tax return position based on the customary tiebreaker tests (for example, permanent home, center of vital interests, habitual abode, and nationality). Rather, dual residents under the treaty are required to request assistance from the U.S. and P.R.C. competent authorities to resolve the question of their residency. The usual relatively straightforward process under most treaties thus becomes far more complex, requiring the direct involvement of tax authorities in both Washington and Beijing.

As a threshold matter, to qualify for the residency tiebreaker analysis under the treaty, an EB-5 investor must be considered a resident of both the P.R.C. and the U.S. under article 4.1 of the treaty, which states that, as relevant for treaty purposes, a resident is any person who, under the laws of that contracting state, is liable to tax therein by reason of his domicile or residence. The technical explanation to the treaty goes on

<sup>33</sup>USCIS Form N-400, "Application for Naturalization," asks at Part 10.C:

Since becoming a lawful permanent resident of the United States:

13. Have you *ever* called yourself a "nonresident" on a Federal, State or local tax return?

14. Have you *ever* failed to file a Federal, State, or local tax return because you considered yourself to be a "nonresident"? [Emphasis in original.]

The USCIS regulations at 8 C.F.R. 316.5(c)(2) state:

An applicant [for naturalization] who is a lawfully admitted permanent resident of the United States, but who voluntarily claims nonresident alien status to qualify for special exemptions from income tax liability, or who fails to file either federal or state income tax returns because he or she considers himself to be a nonresident alien, raises a rebuttable presumption that the applicant has relinquished the privileges of permanent resident status in the United States.

<sup>34</sup>USCIS Form I-131, "Application for Travel Document," asks essentially the same questions at Part 5.

to emphasize that “citizenship is not one of the criteria” for determining residency under article 4.<sup>35</sup> Unlike the rules under U.S. tax law, Chinese nationality alone will not give rise to income tax residency in the P.R.C.

Despite obtaining U.S. income tax residency by virtue of the green card, most Chinese EB-5 investors will remain worldwide Chinese tax residents as well. An individual domiciled in China is subject to Chinese income tax on a worldwide basis. The regulations implementing China’s Individual Income Tax Law specify that “the term ‘individuals who have domicile in China’ means individuals who by reason of their permanent registered address, family, or economic interests, habitually reside in China.”<sup>36</sup> Under this broad test, Chinese EB-5 investors will generally be regarded as Chinese tax residents, as household registration (*hukou*) is rarely abandoned when the green card is obtained, and most green card holders also retain substantial family and economic ties to China.

### Substantive Treaty Rules

Article 4.2 of the treaty provides the tiebreaker process for individuals who, under article 4.1, are both U.S. and P.R.C. residents:

Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then the competent authorities of the Contracting States shall determine through consultations the Contracting State of which that individual shall be deemed to be a resident for the purposes of this Agreement.<sup>37</sup>

In making that determination, article 5 of the 1984 protocol to the treaty directs the competent authorities to apply article 4.2 of the U.N. model treaty, which provides a series of tiebreaker rules substantially the same as the rules contained in the corresponding paragraphs of the OECD and U.S. model treaties. Once established under article 4.2, the residence of the individual remains the same for all purposes of the treaty. The U.N. model treaty’s tiebreaker provisions are to be applied in the following sequence to determine the state of residence:

- Residence exists in the state where the individual has a permanent home. If the individual has a permanent home available in both states, residence exists in the state where his personal and economic relations are closer (that is, the location of his center of vital interests).
- If the center of vital interests cannot be determined, or if the individual does not have a per-

manent home available in either state, residence exists in the state where the individual maintains a habitual abode.

- If the individual has a habitual abode in both states or in neither, residence exists in the state of which he is a national.
- If the individual is a national of both states or of neither, the competent authorities will determine residence by mutual agreement.

In applying these tests, undefined terms are to have the meaning that they have under domestic tax laws unless the context otherwise requires.<sup>38</sup>

#### *Permanent Home / Center of Vital Interests*

The first criterion of the tiebreaker provision under U.N. model treaty article 4.2 begins with a determination of residency based on the location of the individual’s permanent home. The U.N. commentary to article 4, which cites heavily to the OECD commentary, states that the nature of the home is not material (for example, a house or apartment, owned or rented, would suffice), but that permanence is essential, meaning that the home is available to the individual continuously. If the EB-5 investor has retained a permanent home in the P.R.C. while not yet establishing a permanent home in the U.S., the tiebreaker analysis will end at this stage, and the individual should be deemed a Chinese resident under the treaty. However, if the individual has a permanent home in both the P.R.C. and the U.S., the alternative prong of the first criterion bases residence on the location of the individual’s center of vital interests.

In addressing the center of vital interests test, the OECD commentary to article 4, at paragraph 15, states that the facts and circumstances “must be examined as a whole” to determine “with which of the two States his personal and economic relations are closer.” In making this determination, an individual’s “family and social relations, his occupations, his political, cultural or other activities, his place of business, [and] the place from which he administers his property” are among the relevant considerations.<sup>39</sup> To the extent Chinese EB-5 investors have arrived only recently in the U.S., these factors should likely favor a closer relationship with the P.R.C. under the treaty.

The OECD commentary goes on to emphasize that where an individual establishes a home in a second country while retaining a home in the first, “the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions can, together with other elements, go to demonstrate that he has retained his center of vital interests in the first State.” In many instances this reasoning should suffice to tilt the scales

<sup>35</sup>Article 4, Treas. Dep’t Technical Explanations, 1984 China-U.S. Income Tax Agreement.

<sup>36</sup>Regulations for Implementation of the Individual Income Tax Law of the People’s Republic of China, article 2.

<sup>37</sup>Article 24 of the treaty outlines the mutual agreement process.

<sup>38</sup>Article 3.2 of U.N. model treaty.

<sup>39</sup>OECD commentary, article 4, para. 15.



toward the P.R.C., since most EB-5 investors have not abandoned their homes or businesses in the P.R.C., and continue to maintain strong Chinese family and social ties despite establishing a second home in the U.S.

#### *Habitual Abode*

The second criterion bases the residency determination on the individual's place of habitual abode. The OECD commentary suggests that this analysis should take into account the frequency of stays in each state<sup>40</sup> and cover "a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual."<sup>41</sup>

As the OECD commentary suggests, the habitual abode analysis is not simply a day-count test confined to a one-year period. Rather, the analysis must cover a sufficient time period as the facts and circumstances dictate and take into account the "intervals at which stays take place."<sup>42</sup> The habitual abode test is more than a simple arithmetic analysis, as is implied by the following criterion in the tiebreaker sequence (nationality), which is predicated on the individual either lacking a habitual abode in either state, or having a habitual abode in both states.

Depending on the relative amounts of time spent in the P.R.C. and the U.S. during the relevant years, Chinese EB-5 investors may have a strong argument for Chinese residence (and U.S. nonresidence) under the habitual abode test. However, if the amount of time spent in the U.S. far exceeds that spent in the P.R.C. during the relevant period, an EB-5 investor may need to prevail on the permanent home/center of vital interests test in order to successfully achieve sole Chinese residence under the treaty. Alternatively, if habitual abode is found to exist in both the P.R.C. and U.S., the tiebreaker analysis will shift to the question of nationality.

#### *Nationality*

The third prong of the tiebreaker test determines residence based on the individual's nationality. Where the prior tiebreaker criteria are not dispositive, this prong will result in a determination of Chinese residence for Chinese EB-5 investors.<sup>43</sup>

<sup>40</sup>OECD commentary, article 4, para. 17.

<sup>41</sup>*Id.*, article 4, at para. 19.

<sup>42</sup>*Id.*

<sup>43</sup>In general, Chinese law does not allow its citizens to obtain a second passport, but green cards and other forms of non-permanent visas are permitted if not encouraged. Nationality Law of the People's Republic of China, article 3. Further, any Chinese citizen who becomes naturalized as a foreign national will automatically lose Chinese citizenship. Nationality Law of the People's Republic of China, article 9.

#### *Mutual Agreement*

If none of the above-described tests are dispositive, the competent authorities will determine residence by mutual agreement under article 25 of the treaty. Since by definition green card holders have not obtained U.S. citizenship, the tiebreaker analysis will never reach this stage in the EB-5 context.

#### **Procedural Rules: Competent Authority Assistance**

Under article 24.1, requests to the competent authorities for relief of the treaty must be made within three years of the "action resulting in taxation not in accordance with the Agreement." In the EB-5 context, the trigger point giving rise to taxation not in accordance with the treaty is the filing of a U.S. individual income tax return as a U.S. resident, as is required of U.S. lawful permanent residents.

Therefore, it would be prudent for EB-5 investors seeking a residency determination under the treaty to initiate a request for competent authority relief within three years of the filing of a U.S. individual income tax return; alternatively, if filing a formal competent authority request within that time period is not feasible, the EB-5 investor could file a "protective claim" to stay the filing period. This would be the case whether the original return filed was a 1040NR submitted with a Form 8833, "Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)," disclosing the expected competent authority residency determination, or a Form 1040 subsequently amended to reflect nonresident alien status.<sup>44</sup>

EB-5 investors claiming Chinese residency and U.S. nonresidency under the treaty should initiate their requests for relief with the P.R.C. competent authority rather than doing so in the U.S., because primary jurisdiction for making the initial finding of Chinese residency status resides in China. After making a determination that Chinese residency exists under the treaty, the P.R.C. competent authority will initiate consultations with the U.S. competent authority to reach a final determination under article 4. Although a claim of

<sup>44</sup>Interestingly, husband and wife Chinese citizens who become permanent residents of the U.S. as EB-5 investors and then file a joint Form 1040 could face filing issues to the extent they later attempt to file separate amended income tax returns as non-residents under the treaty. Section 6013(a) provides that a husband and wife may file a joint tax return, but the regulations promulgated under that section provide that "for any taxable year with respect to which a joint return has been filed, separate returns shall not be made by the spouses after the time for filing the return of either has expired." Reg. section 1.6013-1(a). Relief should be available as provided in the Internal Revenue Manual, which characterizes Forms 1040 jointly filed by nonresident aliens as erroneous returns. When an erroneous return has been filed, the IRS will allow a nonresident alien husband and wife to change an erroneous Form 1040 joint filing to 1040R separate filings. IRM section 21.8.1.11.6.4 (Oct. 1, 2010).

Chinese residency must begin with the P.R.C. competent authority, it is advisable to initiate a parallel proceeding with the U.S. competent authority under Rev. Proc. 2006-54, 2006-49 IRB 1035. This process for obtaining a residency determination under article 4 from the P.R.C. and U.S. competent authorities is described below in greater detail.

#### *P.R.C. Tax Considerations*

U.S. practitioners should engage the assistance of P.R.C.-based tax counsel in undertaking the request for P.R.C. competent authority relief. As a strategic first step, the EB-5 investor should obtain a Certificate of Chinese Fiscal Resident, which as a threshold matter should confirm that the individual is a Chinese tax resident under the domestic laws of the P.R.C.<sup>45</sup> This process involves a certification process at the local level (city or district) that can generally be completed within several weeks.

To obtain the certificate, the local tax bureau will require a completed application form, a copy of the individual's Chinese identification card (*hukou*) or passport, documentation establishing the source of the individual's income, evidence of family and economic relations, and proof of tax payment for the most recent year (tax payment receipts should suffice).

Although the Certificate of Chinese Fiscal Resident is not required in order to apply for residency determination by the P.R.C. competent authority under the treaty, it is an effective means of positioning the matter for favorable treatment at the competent authority level, given that an initial finding of P.R.C. tax residence has already occurred.

The initial request for P.R.C. competent authority relief must be submitted to the local tax bureau of the province, autonomous region, or municipality of which the individual is a registered domiciliary, and not to the State Administration of Taxation (SAT) headquarters in Beijing.<sup>46</sup> The written application must include the basic identifying information of the individual, a description of the facts of the case, citation to the relevant treaty provisions, information regarding any pertinent interactions between the individual and the U.S. competent authority (including any decision or notice rendered by the U.S. competent authority), and any relevant U.S. precedent.<sup>47</sup>

In determining residence under the treaty, Chinese tax authorities will apply the sequential U.N. model

treaty tiebreaker criteria discussed above. Illustrative of China's commitment to this approach, in guidance issued in 2010 in connection with the China-Singapore tax treaty, which applies to all existing Chinese tax treaties with provisions the same as the China-Singapore tax treaty, the SAT endorsed the same sequence of tests applicable under the U.N. model treaty.<sup>48</sup>

Within 15 days of receiving the application, the local tax bureau will make a preliminary residency determination and transfer the file to the SAT in Beijing.<sup>49</sup> The competent authority in Beijing will then conduct its own evaluation of the application and engage the U.S. competent authority in negotiations in order to reach mutual agreement under the treaty.

#### *Rev. Proc. 2006-54: An Overview*

When EB-5 investors claim Chinese residence under the treaty, the primary application for relief under article 4 must occur in the P.R.C. However, as noted above, it is advisable to initiate a parallel, secondary application with the U.S. competent authority. At a minimum, the U.S. competent authority should be notified of the P.R.C. submission by providing a copy of the P.R.C. request. Although not strictly required, a parallel submission under Rev. Proc. 2006-54<sup>50</sup> is advisable to enable both tax authorities to be fully informed of the relevant facts and applicable law under each country's competent authority procedural rules.

The procedure for requesting U.S. competent authority relief is outlined in Rev. Proc. 2006-54, which, for purposes of a residency determination under article 4 of the treaty, requires a submission similar to that required by the SAT. Specifically, section 4.04 of Rev. Proc. 2006-54 provides a detailed list of submission requirements, some of which may not apply in the context of every request for a residency tiebreaker determination.<sup>51</sup>

<sup>48</sup>Para. 2, article 4 of Interpretations of the Provisions in the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and its Protocols (SAT, Guo Shui Fa [2010] No. 75).

<sup>49</sup>Circular 115, article 11.

<sup>50</sup>Rev. Proc. 2006-54, 2006-2 C.B. 1035. The IRS recently released Notice 2013-78, 2013-50 IRB 633, which proposes a revenue procedure that would update and supersede Rev. Proc. 2006-54. The proposed revenue procedure would substantially restate Rev. Proc. 2006-54 to improve clarity, readability, and organization. A discussion of Notice 2013-78 is beyond the scope of this article.

<sup>51</sup>(1) Identifying details of the individual; (2) brief description of the issues for which competent authority assistance is sought, including a discussion of the underlying facts; (3) description of the control and business relationships between the individual and any related person; (4) years and amounts involved, in both U.S. dollars and relevant foreign currency; (5) IRS office that has

(Footnote continued on next page.)

<sup>45</sup>Circular of the State Administration of Taxation on the Printing and Use of the Certificate of Chinese Resident Status (SAT, Guo Shui Fa [1994] No. 255).

<sup>46</sup>Article 9 of Notice of the State Administration of Taxation on Printing and Distributing the Provisional Measures for Applications by Chinese Residents (Nationals) for Launching Tax Negotiation Process (SAT, Guo Shui Fa [2005] No. 115, effective July 1, 2005).

<sup>47</sup>*Id.* at article 10.

Although the primary request for competent authority assistance must be submitted in China to claim Chinese residence under article 4 of the treaty, a U.S. competent authority request pursuant to Rev. Proc. 2006-54 is an effective means of alerting the U.S. competent authority to the pending SAT determination and may provide an added layer of protection from a timeliness standpoint under the three-year relief period of article 24 of the treaty. Furthermore, before submitting the U.S. competent authority package, it is advisable to informally meet with the appropriate competent authority analyst on the treaty assistance and interpretation team (which handles non-allocation cases) within the Large Business and International Division to preview the facts and circumstances of the particular case.

#### *Predetermination Filing Position*

Because the tiebreaker process under the treaty requires a determination by the U.S. and P.R.C. competent authorities, dual residents under the treaty are placed in the predicament of having to take a return position before the time the mutual agreement process has run its course. Assuming the facts reasonably support a legal position of exclusive Chinese residency, taxpayers are effectively left with no alternative other than to file Form 1040NR with Form 8833 attached to disclose the treaty position, in anticipation of the competent authority determination of Chinese residency.

This issue may arise not only for prospective years (when for each year a new competent authority determination would be required after the close of the tax year), but also for past years when EB-5 investors have not been well advised and have inappropriately filed tax returns as resident aliens. For prior years, amended returns should be filed within the three-year relief pe-

made an adjustment, or that would have jurisdiction over an examination of the individual; (6) nature of requested relief, as well as a statement whether the individual seeks treatment similar to that available under Rev. Proc. 99-32, 1999-2 C.B. 296 (Rev. Proc. 99-32 applies primarily in the section 482 context); (7) statement whether the U.S. or P.R.C. statutes of limitations have expired for the years for which relief is requested; (8) statement disclosing any related domestic or foreign judicial or administrative proceedings involving the individual or related persons; (9) statement of foreign judicial or administrative proceedings, of which the individual is aware, involving the same issue for which competent authority assistance is requested; (10) statement whether the issues underlying the request for competent authority assistance are currently, or have been previously, considered part of an advance pricing agreement; (11) powers of attorney for the taxpayer; (12) if an IRS Appeals office has jurisdiction over the issue in question, a summary of prior communications with the IRS Appeals officer; (13) if the request for competent authority assistance is intended to serve as a protective claim for credit or refund, a statement in accordance with the requirements of section 9.02 of Rev. Proc. 2006-54; (14) statement consenting to disclosure to the competent authority of the treaty partner all information included in the request for U.S. competent authority assistance; (15) penalties of perjury statement; and (16) any other information required elsewhere in Rev. Proc. 2006-54.

riod under article 24 of the treaty in connection with the corresponding request for competent authority relief, which must also be made within three years. Because amended returns will in most cases need to be filed before a competent authority determination has been made, Form 8833 should include a statement explaining the anticipated residency determination.<sup>52</sup>

#### *U.S. Tax Aspects*

Upon agreement by the U.S. and P.R.C. competent authorities that an EB-5 investor is a Chinese resident and U.S. nonresident under the treaty, the individual will be deemed a Chinese resident for all purposes under the treaty. Moreover, Chinese treaty residents are considered dual residents under section 301.7701(b)-7(a) of the Treasury regulations, which provides that a dual resident claiming a treaty benefit as a nonresident of the U.S. will be treated as a nonresident alien of the U.S. for purposes of computing that individual's U.S. income tax liability.

However, although the treaty's residency rules apply for purposes of determining the individual's residence for all purposes of the treaty, the individual will generally be treated as a U.S. resident for purposes of the code other than the computation of the individual's U.S. income tax liability, subject to some limitations.<sup>53</sup> Therefore, for information reporting purposes (such as Form 5471), Chinese treaty residents will generally still be regarded as U.S. residents.

Further, the Treasury regulations provide that a dual resident whose U.S. tax liability is determined as a nonresident alien must timely file Form 1040NR and attach a statement on Form 8833.<sup>54</sup> As noted previously, the filing of a Form 1040NR by an individual may affect the U.S. immigration agencies' determination of whether the individual qualifies to maintain a permanent resident status.<sup>55</sup>

Importantly, the Treasury regulations referenced above do not affect FBAR requirements, which arise under Title 31 rather than Title 26 of the U.S. code. Rather, the Title 31 regulations require that for calendar year 2010 and thereafter, non-U.S. residency under an income tax treaty has no bearing on an individual's

<sup>52</sup>The taxpayer's failure to file Form 8833 with his original returns cannot be used as a basis to deny the taxpayer treaty benefits because it is the treaty, and not the filing of any form, that provides the legal basis for the exemption from gross income. Significantly, and directly on point, the Tax Court has noted that "there is no indication that [the failure to meet the requirements of code section 6114] estops a taxpayer from taking [a treaty-based return] position." See *Pekar v. Commissioner*, 113 T.C. 158, 169, n.5 (1999).

<sup>53</sup>See, e.g., section 894(a) and the flush language of section 7701(b)(6).

<sup>54</sup>Reg. section 301.7701(b)-7(b) and (c).

<sup>55</sup>The old INS has been split into three different agencies, each of which could initiate adverse action if it learned of a 1040NR filing by a permanent resident.

obligation to file the FBAR. The preamble to the final regulations published in the *Federal Register* states that “a legal permanent resident who elects under a tax treaty to be treated as a non-resident for tax purposes must still file the FBAR.”<sup>56</sup>

### Conclusion

While obtaining lawful permanent status through the EB-5 program affords qualifying investors the ben-

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<sup>56</sup>Amendment to the Bank Secrecy Act Regulations — Reports of Foreign Financial Accounts, *76 Fed. Reg.* 10,234, 10,238 (Feb. 24, 2011) (to be codified at 31 C.F.R. pt. 1010).

efits of living permanently and working in the United States, obtaining these rights is not without concurrent obligations, which include compliance with U.S. revenue laws.

Unfortunately, many EB-5 investors are not informed or do not become aware of their U.S. tax obligations until well after they become U.S. tax residents. If those investors had advance knowledge, it may have influenced their decision to become a lawful permanent resident or their personal and tax planning before becoming a U.S. tax resident. In assessing their options, perhaps EB-5 investors should disregard the adage of what happens in China stays in China and become familiar with the warning to keep their eyes wide open. ◆